

Profile of the Economy

Real gross domestic product

GROWTH IN REAL GROSS DOMESTIC PRODUCT (GDP) accelerated in the first quarter of 1996 from the sluggish pace at the end of 1995. GDP expanded at a 2.8 percent annual rate in the first quarter and that would have been even faster if not for the General Motors strike. GDP increased 0.5 percent at an annual rate in the fourth quarter of 1995. During the four quarters of 1995, growth was just 1.3 percent.

Consumer spending improved and rose at a 3.5 percent pace in the first quarter versus 1.2 percent in the fourth quarter of 1995. Business investment grew to a 12 percent rate from 3 percent in the final quarter of 1995. There was also a rebound in Federal spending after the shutdown contributed to a sharp decline in the fourth quarter. Deterioration in the net export balance was a major negative element in the first quarter.

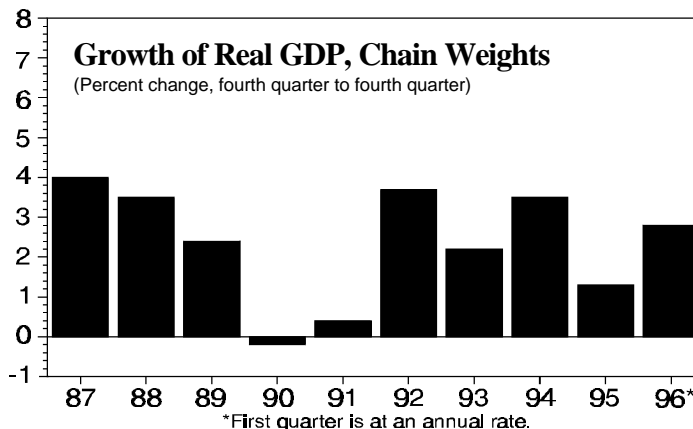
Inflation, as measured by the chain-weighted price index for GDP, increased at a 2.5 percent annual rate in the first quarter, only a little faster than the 2.2 percent gain the previous quarter. Prices paid by U.S. residents, excluding exports and including imports, also rose at a 2.5 percent rate.

During the rest of 1996, GDP growth is projected to moderate to a steady pace that is consistent with low inflation. Private forecasters and the Administration expect growth in the 2 to 2-1/2 percent range for the entire year.

Consumer and producer prices

Inflation was very moderate in 1995. The consumer price index (CPI) rose by only 2.5 percent over the year, the fourth straight year that consumer inflation was below 3 percent. So far in 1996 price gains accelerated slightly, mainly due to temporary increases in energy and food prices. Through the first 4 months of the year, the CPI rose at a 4.1 percent annual rate, while growth in core inflation, excluding food and energy, was just 3 percent, the same as in 1995.

The producer price index (PPI) for finished goods has also registered some acceleration early in 1996, particularly for energy. After rising by 2.3 percent in 1995, the PPI was



up at a 3.0 percent annual pace in the first 4 months. Excluding food and energy, however, that gain was just 0.4 percent at an annual rate compared with growth of 2.6 percent in 1995. Core prices at earlier stages of processing have also been very well behaved so far this year.

The cost of compensating labor has shown little evidence of inflationary pressures. The employment cost index (ECI) rose by 3 percent over the 12 months ending in March, about in line with the gain during 1995. Benefit costs actually edged down in the first quarter, while growth in wage costs picked up slightly from previous quarters.

Real disposable personal income and consumer spending

Real disposable (after tax) personal income has continued to grow into 1996, after a solid performance last year. Following a 3 percent rise during the course of 1995, disposable (after-tax) personal income adjusted for inflation rose by 3.2 percent at an annual rate in the first quarter. This was a good performance, especially in view of the General Motors strike, which cut into wages in March.

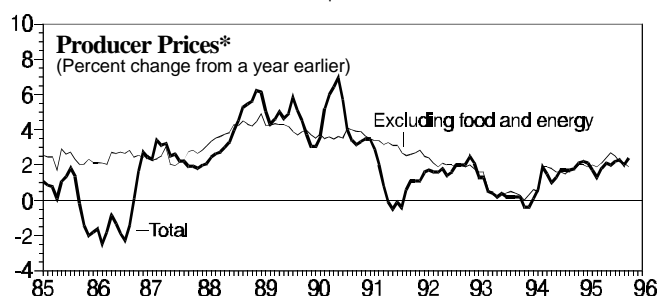
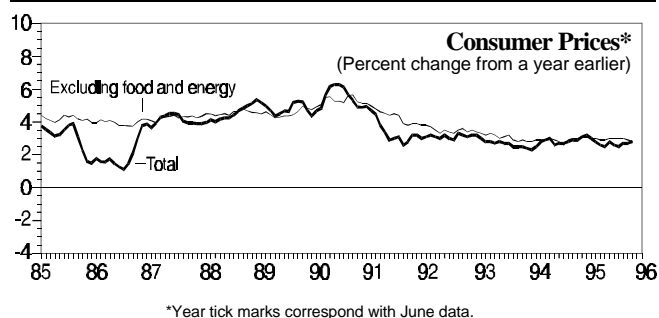
Consumer spending increased at a healthy 3.5 percent annual rate in the first quarter, after a lackluster 2 percent rise during 1995. Nonautomotive discretionary goods (such as furniture and apparel) and gas and electricity (needed for the severe winter weather) led the first quarter gains.

The share of after-tax income devoted to personal saving was 4.8 percent in the first quarter, little changed from the fourth quarter but up from 4.5 percent for all of 1995 and the weak 3.8 percent in 1994. Recent figures remain low compared to the 7.7 percent averaged from 1959 to 1986.

Industrial production and capacity utilization

Growth of industrial production in manufacturing, mining, and utilities improved in the first quarter from a weak pace at the end of 1995. Production expanded by 2.7 percent at an annual rate in the first quarter compared with growth of just 0.6 percent in the fourth.

Contributing to the growth in the first quarter was a rebound in the production of aircraft and parts, which had been affected by a strike at Boeing late in 1995. The pace in the first quarter would have been even higher if not for some special factors such as a strike against General Motors, which held down motor vehicle output. In the first quarter, industrial production growth was at a strong 4.3 percent annual rate, excluding motor vehicles and parts.



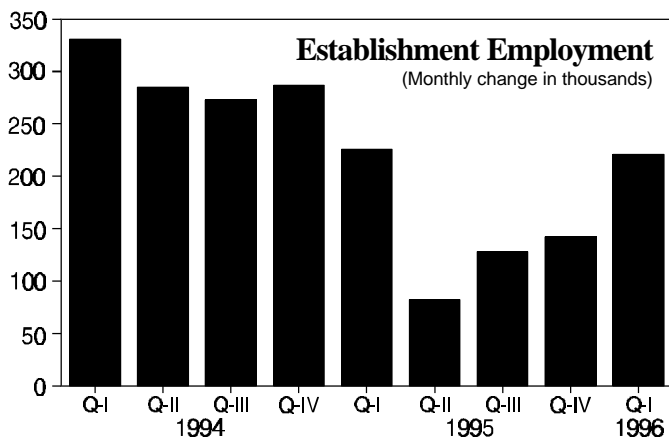
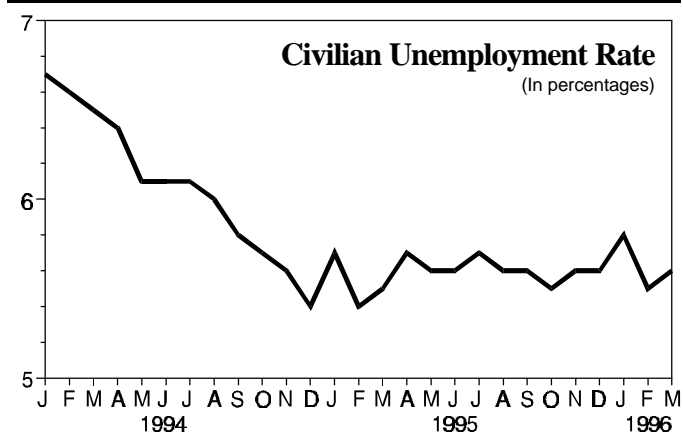
The capacity utilization rate was 82.7 percent in the first quarter, slightly above its long-term average but well below the 15-year high that was reached early in 1995.

Employment and unemployment

Employment growth continued to accelerate in the first quarter of 1996 to an average of 221,000 jobs per month compared with 142,000 in the final quarter of 1995. While job growth has risen since the second quarter of 1995, results for April 1996 showed virtually no improvement, but technical factors could have affected the figures.

The private service-producing sector added most of the new jobs. Increases in this sector totaled 1.7 million in 1995, with an additional 650,000 new jobs added through the first four months of 1996. In contrast, the manufacturing sector has been weak. Factory jobs fell by 338,000 between March 1995 and April 1996 after steady gains through 1994.

The unemployment rate fell steadily during 1994, and since October of that year has hovered in a narrow range of 5.4 percent to 5.8 percent. By historical standards, this band is quite low.



Nonfarm productivity and unit labor costs

Nonfarm productivity, or output per hour worked, increased at a sluggish 0.7 percent in 1995. Productivity growth so far during the 1990's has averaged a 1 percent annual rate, the same as during the 1980's, but down from 1.9 percent during the 1970's and 2.9 percent during the 1960's.

Hourly compensation costs in the nonfarm business sector rose by 4.1 percent over the four quarters of 1995, up from 2.5 percent during 1994. As a result of the more rapid increases in compensation than in productivity, labor costs per unit of output accelerated to 3.4 percent in 1995, the biggest increase in 5 years.

Productivity in manufacturing, a component of the nonfarm sector, grew at a much more rapid pace than in the nonfarm business sector as a whole, rising by 3.7 percent during the four quarters of 1995. As a result of the faster gains in productivity, unit labor costs in the manufacturing sector improved, declining in 1995 for the second consecutive year.

Current account balance

The current account balance encompasses U.S. international trade in goods, services, and income payments. The current account deficit had widened sharply in recent years as the economic recovery here brought in imports at a faster pace than the rate of expansion in exports. That deterioration slowed in 1995. Last year the deficit was \$153 billion, just slightly above the \$151 billion in 1994. An improved merchandise trade balance was primarily responsible.

The merchandise trade deficit narrowed to an average of \$13.1 billion a month from August through December in 1995, compared with \$15.6 billion earlier in the year. For 1995 as a whole, however, the merchandise trade deficit totaled \$174.6 billion, the largest on record.

International trade in services showed a \$63 billion surplus in 1995. That was a little better than figures for the 3 previous years.

The balance on income payments, which includes interest, dividends, and direct investment income, shifted from a surplus of \$9 million in 1993 to a deficit of \$11.4 in 1995. The main contributor to that deficit was Federal Government interest payments to the rest of the world.

Exchange rate of the dollar

The dollar strengthened over the second half of 1995 and on into 1996 after steady deterioration beginning in early 1994. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, the dollar dropped close to an all-time low in April 1995. Through the end of 1995 the dollar increased by 4 percent and a further 2.8 percent in the first four months of 1996.

Most of the dollar deterioration was against the yen and the deutschemark, and the improvement was also greatest against these currencies. Since April 1995, the dollar has increased by almost 9 percent against the deutschemark and by 28 percent against the yen.

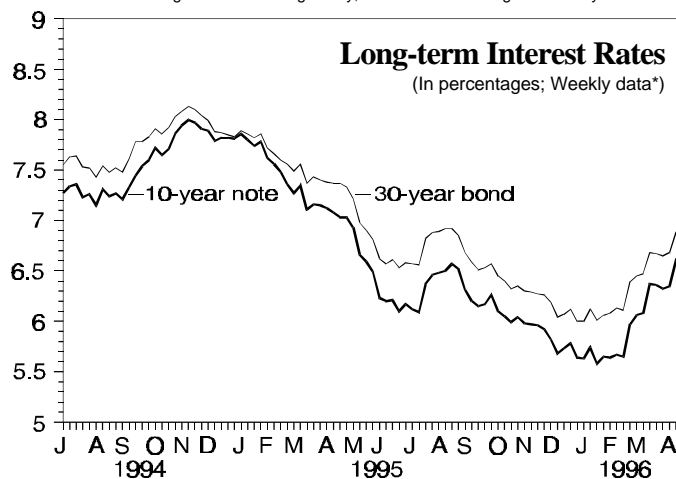
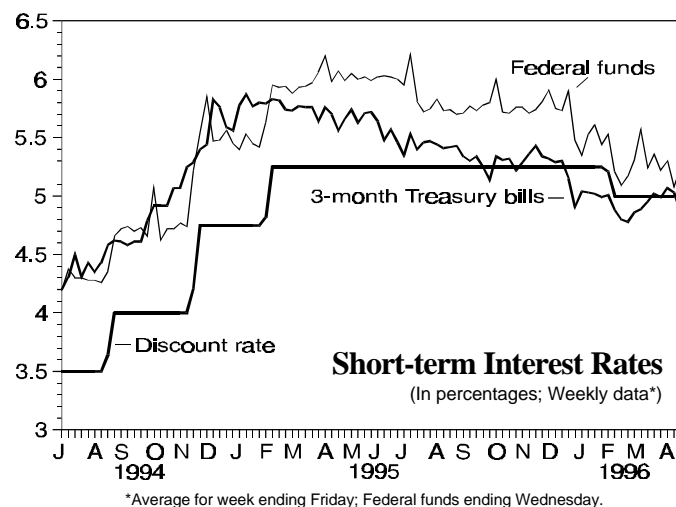
Despite the improvement, the dollar remains about 10 percent below its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. The large U.S. current account deficit likely played a role in the earlier downward movement of the dollar. Underlying economic fundamentals in the United States remain sound, however.

Interest rates

Long-term interest rates have moved higher in 1996 after declining over the second half of last year. The yield on the 30-year Treasury bond increased from a recent low of 6.0 percent in January to a current rate of about 6.8 percent. Stronger jobs and income growth contributed to the upward movement.

Mortgage interest rates have also increased but remain extremely favorable. Earlier this year the rate for a 30-year fixed-rate conventional loan was 7 percent, close to the 25-year lows reached in October 1993. Rates are currently at about 7.9 percent, still quite low by historical standards.

Short-term interest rates have moved lower this year. The Federal Reserve Board eased monetary policy in January for the third time in the current cycle. Since last July, the Board has reduced the target for the Federal funds rate by a total of 75 basis points, to 5-1/2 percent, and has lowered the discount rate by a total of 25 basis points, to 5 percent.



Net national saving and investment

Net national saving is the saving available for investment in the expansion of structures and equipment used by U.S. workers. Depreciation to replace obsolete capital is included in gross saving. In 1995, net national savings rose to 4.9 percent of net national product (NNP) from 3.9 percent

in 1994 and 2.7 percent in 1992. That was the lowest in the history of the series. Net savings had averaged as high as 12 percent of NNP in the 1960's.

Gains over the past 3 years reflect the narrowing of the Federal deficit, which has reduced Government dissaving to 1.6 percent of NNP in 1995 from 3.9 percent in 1992. Private savings, of households and businesses, was equivalent to 6.9 percent of NNP in 1995, up from the historical low of 6.4 percent in 1994. Private saving had averaged nearly 10 percent of NNP in the 1960's and 1970's.

Net domestic investment equaled 7.2 percent of NNP in 1995, up from a low of 4.1 percent in 1991. Foreign inflows accounted for 2.2 percent of NNP in 1995, or nearly one-third of domestic investment. U.S. sources provided investment equivalent to 5 percent of NNP, only half the shares of NNP averaged in the 1960's and 1970's.

Housing

Housing activity has improved after the unusually severe weather in January. Housing starts averaged 1.47 million units at an annual rate in the first quarter, close to their expansion high of 1.48 million units in the fourth quarter of 1994. Both single- and multi-family housing starts were strong in the first quarter.

Single-family home sales have been brisk, as improvements in employment growth and consumer confidence as well as lower mortgage interest rates have stimulated housing market activity. New home sales dipped in March, but were quite strong in January and February. Existing home sales have expanded rapidly in the past few months, spurred by the low mortgage rates at the beginning of the year.

Although rates have risen from levels that were near 25-year lows in January and February, they are still quite moderate by historical standards. Favorable rates and growing employment should continue to support the housing market, but it is unlikely there will be additional large gains. The level of housing activity is fairly high for this stage of the business cycle, and further rapid expansion is doubtful.

Federal budget deficit

In fiscal 1995, the Federal deficit fell to \$164 billion. That figure was \$39 billion lower than the \$203 billion deficit in fiscal 1994 and \$127 below the record \$290 billion deficit in fiscal 1992. The 3-year drop was the largest in history and the first such successive declines since the Truman Administration.

Outlays rose by only 4 percent in fiscal 1995, while receipts expanded by 7.8 percent. The deficit represented 2.3 percent of gross domestic product (GDP), well below the 4.9 percent share in fiscal 1992 and the lowest in 16 years.

The deficit is projected to fall further in fiscal 1996, to \$146 billion or just 2 percent of GDP. So far through the first half of fiscal 1996, indications suggest that the deficit will come in a bit below that figure. The budget is projected to reach balance in fiscal 2001 under the Administration's economic assumptions.